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Statement of
Alan Greenspan
Chairman
Board of Governors of the Federal Reserve System
before the
Committee on the Budget
House of Representatives

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I am pleased to appear here today to discuss some of the important issues related to the outlook for the economy and the attendant implications for the formulation of fiscal policy. The views I will be expressing are my own and not necessarily those of the Federal Reserve Board.

The U.S. economy has confronted very significant challenges over the past year--major declines in equity markets, a sharp retrenchment in investment spending, and the tragic terrorist attacks of last September. To date, the economy appears to have withstood this set of blows well, although the depressing effects still linger and continue to influence, in particular, the federal budget outlook. A year ago, the Congressional Budget Office expected the unified budget to post large and mounting surpluses over the coming decade. As you know, CBO is currently forecasting that, if today's policies remain in place, the unified budget will post deficits through fiscal year 2005. For the fiscal year just ending, CBO now projects a budget balance that is more than \$300 billion below the level it had projected a year ago.

To a degree, the return to budget deficits resulted from temporary factors, especially the falloff in revenues and the increase in outlays associated with the economic downturn. But some of the factors accounting for the weaker budget outlook will have longer-lasting effects. A large portion of this year's decline in individual income tax revenues is clearly related to the retrenchment in equity markets. The sharp decline in stock prices appears to have markedly reduced final settlements for the 2001 tax year, as well as receipts on 2002 income. This effect works directly through less tax revenue from capital gains realizations, and indirectly through less revenue collected from the exercise of stock options, from stock-price-related bonuses, and from withdrawals from IRAs and 401(k) plans that have been augmented by capital gains.

Although official projections had been based on the assumption that tax collections related to the stock market would eventually decline from the elevated levels of the late 1990s,

the sharp drop in equity markets was not expected, and the fallout from it will likely damp tax revenues relative to earlier expectations for some time. Furthermore, the precipitous fall in tax receipts may have resulted from other factors as well--for example, a shift in the distribution of income from higher to lower tax brackets and a change in the timing of tax collections. The recent surge in discretionary spending, necessitated only in part by the war on terrorism and the need for enhanced homeland security, has also made the budget picture less sanguine.

Nonetheless, despite the budget erosion over the past year, our underlying fiscal situation today remains significantly stronger than that of a decade ago, when policymakers were struggling to rein in chronic large deficits and the ratio of federal debt to gross domestic product was approaching 50 percent and climbing. This turnaround was the result of several factors. To an extent, the fiscal improvement can be traced to the emergence of forces largely external to the fiscal process. The end of the Cold War yielded a substantial peace dividend, and the pickup in productivity growth and surging stock market substantially boosted tax collections.

But such forces alone cannot wholly account for the improvement in the fiscal situation. Prudent policy also played an important role. After years of budgetary profligacy, a political consensus to move toward a balanced budget slowly emerged. Beginning in the late 1980s, impressive progress was made in restraining federal expenditures and restoring a better balance between spending and revenues.

Even with a consensus to balance the budget, such progress might have been elusive were it not for the procedural mechanisms that were developed to enforce that political consensus. The Budget Enforcement Act of 1990, building on earlier initiatives, provided such mechanisms. The statutory limits on discretionary spending and the so-called PAYGO rules

requiring changes in mandatory spending and revenue policies to be budget-neutral, backed by a 60-vote point of order in the Senate, served as useful tools to control deficits. In essence, the rules provided a means for advancing the broader good of sound fiscal policy over narrower interests.

The budget rules worked far better than many skeptics, myself included, had expected. Between 1990 and 1998, discretionary spending fell from more than 10 percent of GDP to less than 6 ½ percent. The end of the Cold War was clearly a critical factor behind this decline, but the statutory caps helped to hold nondefense discretionary expenditures in check, and allowed the benefits of the decline in defense needs to go toward reducing deficits rather than toward facilitating increases in other spending. The PAYGO rules changed the way policymakers analyzed fiscal policy proposals: Rather than focusing solely on the benefits of a proposal, policymakers were required to recognize the costs as well.

The Budget Enforcement Act was intended to address the problem of huge deficits. In 1990, the possibility that surpluses might emerge within the decade seemed remote indeed. When they unexpectedly arrived, the budget control measures appeared to be addressing a problem that had been solved. Fiscal discipline seemed a less pressing priority and was increasingly abandoned. Though the 1990 act was not amended, policymakers found ways to circumvent the discretionary caps and the PAYGO rules. They did not anticipate--and, indeed, there were few indications--that deficits were about to reemerge. Given the recent change in budget outlook, the commitment to fiscal responsibility that served us so well must now be reestablished.

The budget enforcement rules are set to expire on September 30. Failing to preserve

them would be a grave mistake. For without clear direction and constructive goals, the inbuilt political bias in favor of budget deficits likely will again become entrenched. We are all too aware that government spending programs and special tax benefits can be easy to initiate or expand but extraordinarily difficult to trim or shut down once constituencies develop that have a stake in maintaining the status quo. However, spending and tax-cutting restraint are not symmetrical. While there is no upside limit to spending, taxes cannot go below zero. In any case, the bottom line is that if we do not preserve the budget rules and reaffirm our commitment to fiscal responsibility, years of hard effort could be squandered.

In considering the extension of the Budget Enforcement Act, some have suggested amending the budget rules to limit the scope for circumventing the spending caps through the use of an “emergency” spending designation. Others have suggested rules that would be more flexible in the event of budget surpluses. These are thoughtful initiatives, but they are secondary to ensuring that the basic framework not be abandoned. Restoring fiscal discipline must be a high priority.

Besides the near-term budgetary shortfalls that we currently face, the aging of the population presents a daunting long-term fiscal challenge. Indeed, the extent of that challenge is not adequately reflected in conventional measures of the federal budget.

Scoring the budget on an accrual basis--the private sector norm and, I believe, a sensible direction for federal budget accounting--would better underscore the tradeoffs we face. Under accrual accounting, benefits would be counted as they are earned by workers rather than when they are paid out by the government. This method allows us to keep better track of the future obligations that the government has incurred. Under full accrual accounting, the social security

program would have shown a substantial deficit last year, rather than the surplus measured under our current cash-accounting regimen.

Such accruals take account of still-growing contingent liabilities, which currently, under most reasonable sets of actuarial assumptions, amount to many trillions of dollars for social security benefits alone. The contingent liabilities implicit in the Medicare program are much more difficult to calculate--but they are also likely in the trillions of dollars. These liabilities are fast approaching their due date. With the baby boom generation beginning to retire in just six short years, cash benefits will soon begin to rise rapidly, exerting pressure on the unified budget.

Given the imminence of these demographic pressures, we need to begin deciding exactly how to reform our retirement programs to close the gap between unified budget outlays and revenues. In essence, we will have to decide how to allocate available resources. All possible policy should be on the table. Recently, the Bureau of Labor Statistics introduced a new index that could provide a more accurate measure of the cost of living for the indexation of both retirement benefits and tax brackets.¹

More fundamentally, the way to prepare for the challenges ahead is to increase the real resources that will be available to meet those looming needs. The greater the resources available --that is, the greater the output of goods and services produced by our economy--the easier it will be to provide real benefits to retirees without unduly restraining the consumption of workers and without imposing large tax increases that would damp incentives and reduce economic growth.

1. This "chained CPI" series is subject to revision. Indexing benefits to the level of the index, rather than the change, would capture not only the most recent changes in the index, but also the accumulated revisions not previously captured.

Although other elements are involved in long-run productivity growth, clearly, the more capital that is available per worker, the greater productivity will be, all other things being equal. The level of national savings, the primary source of capital investment financing, is significantly affected by the level of government saving (surpluses) or dissaving (deficits). Between 1992 and 2001, decreasing federal budget deficits followed by surpluses were important to maintaining national saving in the face of declining private saving, a factor likely contributing to the marked step-up in productivity growth.

Returning to a fiscal climate of continuous large deficits would risk returning to an era of high interest rates, low levels of investment, and slower growth of productivity. To be sure, at the moment, Treasury rates are at the lowest level in more than forty years, and I can scarcely argue that deficits are pressuring interest rates. And, indeed, our current fiscal situation remains more favorable than it has over much of the past few decades. But history suggests that an abandonment of fiscal discipline will eventually push up interest rates, crowd out capital spending, lower productivity growth, and force harder choices upon us in the future.

To summarize, now is not the time to abandon the discipline and structure that worked so well for so long. The framework enacted in the Budget Enforcement Act of 1990, and extended several times, must be preserved. Current budget projections remain relatively favorable, but those projections will be realized only under a disciplined approach to fiscal policy. Though undeniably difficult, following such a strategy will best prepare us for the fiscal pressures that will almost surely arise as the baby boom generation begins to retire.